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IN THE

Supreme Court of the United States

October Term, 1988

ARTHUR D. LITTLE, *et al.*,

Petitioners,

v.

RICHARD LESSLER,

Respondent.

Brief in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the First Circuit

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I.

Counter-Questions Presented.

1. Whether the issues raised in the Petition are hypothetical and premature because it has not yet been determined whether a Section 17(a) (of the Investment Company Act) violation has in fact occurred, and the Court of Appeals has remanded the case to the District Court for just such a determination?

2. Whether the amended complaint states a valid claim under the Investment Company Act of 1940?

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Counter-Statement of the Case.

1. The Background Facts.

This case involves unique facts but tried and true legal principles.

It involves a 1986 "going private" by Narragansett Capital Corporation (the "Corporation"), a company that was registered pursuant to the Investment Company Act as a closed-end non-management investment company. The inside directors of the Corporation—defendants Little, Manchester, Barber, Vandenberg, Nelson and McNulty—also owned a separate company, Narragansett Manage-

ment Company (the "Management Company") which had acted over the years as the Corporation's investment adviser. The Corporation was in the business of buying large equity positions in a variety of small (often not publicly held) companies and then selling those positions, hopefully for a profit.

The Complaint alleges that as a result of the "going private" transaction, the Management Company (i.e., the Corporation's inside directors), ended up with a 20% interest in the assets that were sold to the third party, defendent Monarch Capital Corporation ("Monarch").* Since Monarch's announced plan was to sell all of those purchased assets, the Management Company's 20% interest would be reduced to cash in a very few years. As explained below, it was the fact that the Management Company (i.e., the inside directors) would, at no cost to themselves, retain a 20% interest in the Corporation's assets that prompted this lawsuit. Of course, defendents do not admit that they obtained a 20% interest in the Corporation's assets at no cost. Rather, they claim that their 20% interest is really only fair payment for rendering investment advice to Monarch. The Complaint alleges that the so-called investment advisory contract is "a sham" to mask the truth.

The same Corporate insiders sought to obtain the same 20% interest in the Corporation's assets two years earlier, in 1984. They submitted an application to the Securities and Exchange Commission on April 12, 1984, and sought an exemption under Section 17 of the Investment Company Act. When that exemption was not granted defendants withdrew their application; a few months later they proposed the 1986 "going private," which is the transaction

*That 20% interest is in addition to the more usual management fee of 2%-3% of the assets that the Management Company also receives.

here in issue. The complaint alleges that the defendants, when they withdrew their application from the S.E.C., sought to by-pass Section 17 of the Investment Company Act by the unique and oblique technique of obtaining the very same 20% interest in the Corporation, albeit by calling it "investment advisory" fees.

The proxy statement, dated September 19, 1986, advised the Corporation's shareholders that the Corporation and all of its assets were being sold to a third party, defendant Monarch, and that each shareholder of the Corporation would receive consideration of $56 per share. The proxy statement disclosed that Monarch planned to liquidate all of the Narragansett assets it purchased, over the next few years, and would retain the Management Company to do the job. For its efforts, the Management Company would be paid between 2% and 3% of the assets it was managing (the so-called Management Fee) plus 20% of all the profits realized on the liquidation (the so-called 20% Contingent Fee). That 20% interest would, concededly, yield to the Management Company, in a very few years, a very tidy sum indeed; the proxy statement itself projects that the assets, bought for $122 million, would be sold for $245 million.* These fees were described in the proxy statement as "investment advisory fees."

The thrust of the complaint (brought in the United States District Court for the District of Rhode Island) is that Monarch's agreement to pay the Management Company 20% of the profits (on the sale of the assets that Monarch had bought from the Corporation) was unlawful, and that that 20% belonged to all of the Corporation's shareholders.

*The entire difference would not be profit; there is a formula that includes expenses, and a return on investment for Monarch.

The Statutory Violations.

The Complaint alleges that the 1986 "going private" transaction violated both the Investment Company Act (Sections 17(a), 36, 47(b) and 48(a)) and the Securities Exchange Act of 1934 (Sections 10(b) and 14(a)). We note particularly the inter-connection between Sections 17 and 36(b) of the Investment Company Act; Section 36(b), by its terms, excludes transactions covered by Section 17. Since Section 36(b) is directed at excessive investment advisory fees, and since defendants themselves described their 20% interest as an " investment advisory fee," the Complaint pleaded that the challenged transaction violated (in the alternative) both Sections 17(a) and 36(b). The Court of Appeals upheld only the Section 17(a) claim so that, technically, that is the only section now before the Court.

3. The Proceedings Below.

Defendants, prior to answer and discovery, moved to dismiss the complaint pursuant to Rules 12(b)(6) and 9(b) of the Federal Rules of Civil Procedure, and the District Judge (Pettine, J.) referred the motions to a magistrate. The magistrate issued a Report and Recommendation on September 29, 1987 (the "Report"*) recommending that defendants' motions for dismissal be granted. Without a hearing, the District Court adopted the Report and dismissed the complaint.

The essence of the Report is that the sale of the Corporation's assets to Monarch was separate from, and not related to, the investment advisory contract between Monarch and the Management Company. Hence the Report held that

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*The Report and the Circuit Court's opinion are annexed to the Petition.

there were no violations of federal law involved in connection with the sale of the Corporation's assets to Monarch.

In particular, the Report found no violation of Section 17(a) of the Investment Company Act because of the finding that the two contracts signed by Monarch (its purchase of the Corporation's assets and the contrast for investment advisory services) were separate and distinct. Although the Report specifically found that no violation of Section 17(a) had been pleaded, it also found (inconsistently) no violation of Section 36(b) (of the Investment Company Act) on the ground that Section 36(b) specifically excludes transactions subject to Section 17. The Report also dismissed the claims asserted under the Securities Exchange Act on the general ground that Rule 9(b), which requires that allegations of fraud must be pleaded with particularity, had not been complied with.

The District Court approved the Report as submitted without argument, and an appeal to the First Circuit Court of Appeals followed.

The First Circuit (per Judges Bownes, Breyer and Caffrey) unanimously reversed on the basic Investment Company Act allegation but affirmed the dismissal on all Securities Exchange Act allegations. In particular, the Court held that, based on the unique and very special facts of the case, a violation of Section 17(a) of the Investment Company Act had been pleaded. The Court noted that the defendants had (i) applied to the S.E.C. for approval, (ii) then withdraw their application for a 20% interest in the Corporation from S.E.C. consideration and, (iii) then themselves proposed a variation of that same theme by seeking the same 20% interest, albeit through the oblique device of the so-called investment advisory contract. The Court also noted the Report's inconsistency of dismissing the Section

17 claim and then also dismissing the Section 36(b) claim on the ground that Section 36(b) specifically excludes transactions covered by Section 17. In choosing between which of those two mutually exclusive sections to sustain, the First Circuit chose Section 17(a). As a result of the proceedings below, only the Section 17(a) claim is, technically, before this Court.

With this brief summary of events as background, we respectfully submit that the Petition for a Writ of Certiorari should be denied.

ARGUMENT.

The petition for a writ of certiorari should be denied.

I. The case is unique.

This is a most atypical case, involving an alleged attempt by defendants to circumvent Section 17(a) of the Investment Company Act by entering into a "sham" transaction involving a so-called investment advisory contract pursuant to which they would receive 20% of the profits as the Corporation's assets are liquidated (in addition to a payment of 2%—3% of the value of the assets being managed). We have found no precedent for such obliqueness. Having first sought and then withdrawn their application before the S.E.C. (for an exemption to allow them to obtain a 20% interest in the Corporation), defendants should be the last persons to argue that only the S.E.C. can hear this alleged violation of Section 17.

At any rate, our research (and petitioners'; see Petition p.13) has uncovered no case with a factual situation even remotely similar to this one. Such a one-time transaction does not merit this Court's review.

II. Petitioners' contention that there is a conflict or a genuine doubt about the right to assert a private right of action under the Investment Company Act is not correct.

Petitioners' underlying theme is that the law is still unsettled as to whether there exists any private rights of action (except for claims under amended Section 36(b)) under the Investment Company Act of 1940. In fact, however, private rights of action have long been sustained in a broad variety of Investment Company Act cases. See, particularly, Judge Friendly's oft-quoted decision *Fogel v. Chestnutt,* 668 F.2d 100 (2d Cir. 1981) (*Fogel II*), cert. denied 459 U.S. 828 (1982); Judge Friendly carefully distinguished, for Investment Company Act cases, this Court's decision in *Transamerica Mortgage Advisors, Inc. v. Lewis,* 444 U.S. 11 (1979), on which petitioners so heavily rely. Accord: *Brown v. Bullock,* 294 F.2d 415 (2d Cir. 1961); *Rosenfeld v. Black,* 445 F. 2d 1337 (2d Cir. 1971); *Taussig v. Wellington Fund, Inc.,* 313 F.2d 472 (3rd Cir. 1983), cert. denied 374 U.S. 806 (1963); *Levitt v. Johnson,* 334 F.2d 815 (1st Cir. 1964) cert. denied 379 U.S. 961 (1965); *Moses v. Burgin,* 445 F.2d 369 (1st Cir. 1971) cert. denied 404 U.S. 994 (1971); *Greater Iowa Corp. v. McLendon,* 378 F.2d 783 (8th Cir. 1967); *Fogel v. Chestnutt,* 533 F.2d 731 (2d Cir. 1975) (*Fogel I*), cert. denied, 429 U.S. 824 (1976); *Bancroft Convertible Fund, Inc. v. Zico Investment Holdings, Inc.,* 825 F.2d 731 (3rd Cir. 1987). *Bancroft,* it should be noted, relied upon this court's decision in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran,* 456 U.S. 353 (1982).

We underscore that Judge Friendly's decision in *Fogel II* specifically dealt with this Court's decision in *Transamerica* and its relationship to a private right of action under the Investment Company Act. When petitioners in *Fogel II* sought a review of that decision, this Court denied certiorari, at 459 U.S. 828 (1982). *Fogel II* raised the issue of a

private right of action under the Investment Company Act squarely. By contrast, this case raises it in a most indirect way. If so fundamental change in the law is to be made—if a private right to bring an action under the Investment Company Act is henceforth to be denied—it should be done in a case where the issue is more neatly presented than it is in this unique factual context. As the authorities above demonstrate, from 1940 until now, the law has been clear: There is a private right of action under the Investment Company Act.

III. A private right of action has been recognized under Section 17 of the Investment Company Act; but in any event the issue is hypothetical and premature.

As petitioners concede (at p.13), many cases have upheld a private right of action, specifically, under Section 17 of the Investment Company Act. *Krome v. Merrill Lynch & Co. Inc.*, 637 F. Supp. 910 (S.D.N.Y. 1986); *Goodall v. Columbia Ventures, Inc.*, 374 F. Supp. 1324 (S.D.N.Y. 1974); *Entel v. Allen*, 270 F. Supp. 60 (S.D.N.Y. 1967). These cases are in accordance with the broad holdings that have upheld private rights of action under the Investment Company Act, *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1981). See, *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964) and *Fogel v. Chestnutt*, 668 F.2d 100 (2d Cir. 1981) (*Fogel* II), cert. denied 459 U.S. 828. See, too, *Cort v. Ash*, 423 U.S. 66 (1975) (plaintiff being a member of the class protected by the Act, as set forth in *Brown v. Bullock, supra*). Indeed, the petition concedes that the Circuit Courts have *not* divided on the question of whether a private right of action may be brought under Section 17 (Petition, p.13).

Petitioners suggest that the statutory scheme of Section 17(a), in the context of the Investment Company Act, requires the S.E.C.'s expertise. But at bar it is these very

defendants themselves who withdrew their application from S.E.C. consideration. Had they not done so, the S.E.C. would have acted on their application, and those affected persons who were dissatisfied with the result could have pursued an appeal through the judicial system. It is thus petitioners who have sought to frustrate the statutory scheme, not respondent.

One further point on the S.E.C.: The Petition appears to suggest (at p. 9) that because a proxy statement went out, that that somehow implies S.E.C. approval of the transaction. But, of course, the issue of a Section 17(a) (Investment Company Act) violation was never discussed with or by the S.E.C. Furthermore, Rule 14a-9(b) pursuant to the Securities Exchange Act (17 C.F.R. Section 240.14a-9(b)) specifically provides that the fact that a proxy statement has been filed with, or examined by, the S.E.C. "shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders".

In any event, the issue is hypothetical and premature because there has been no determination that Section 17(a) has, in fact, been violated; and the relevant facts are in dispute. The First Circuit remanded the case for discovery on that issue, and there is yet to be a trial on whether the facts establish such a statutory violation. The Court held that the defendants will not be liable unless plaintiff can prove that the two contracts with Monarch (the contract pursuant to which Monarch purchased the Corporation's assets and the contract by which Monarch retained the Management Company as the investment adviser) were related. Even if plaintiff establishes that, the Court held that he would still also have to prove that the so-called invest-

ment advisory fee was so excessive that it amounted to giving the Management Company an equity position in the Corporation. In short, a Section 17 violation has not yet been established.

We suggest that defendants (the Petitioners) would be the first to assert that no violation of Section 17 will ever be established. Hence consideration of whether or not plaintiff can maintain a Section 17 action, were it some day proven, is both hypothetical and premature. There is nothing for this Court to review at this time. For instance, had the District Court sustained the complaint (the way the First Circuit did), that order, not being final, would not have been appealable. For the same reasons, this Court should not entertain this appeal.

IV. Claims under Section 17 of the Investment Company Act are rare.

As the Petition concedes, there have been only a handful of cases arising under Section 17 since the Investment Company Act was passed in 1940 (Petition p.13).

Whether or not there is a private right of action under Section 17 is of specific concern to very few people. Surely dramatic new law—denying a private right of action under the Investment Company Act—should not be announced in so narrow an area of legal interest.

Cases under Section 17 are rare because, typically, interested parties apply to the S.E.C. for an exemption (which is either granted or not). It is very uncommon to do what defendants have done here—themselves try to circumvent Section 17 by devising an indirect method of self-dealing. Such a once-in-a-lifetime circumstance does not require this Court to act.

CONCLUSION.

The petition for certiorari should be denied because the case is a unique one without broad application; there is no conflict because a private right of action under the Investment Company Act in general and under Sections 17 in particular is old, established law; in any event, the issue of whether there is a private right to sue under Section 17 is premature and hypothetical, because no such violation has been (or may ever be) established; and if this Court wishes to change old, established precedents, this would be among the least appropriate cases to do so. Compare, *Fogel v. Chestnutt,* 668 F.2d 100 (2d Cir. 1981), in which certiorari has denied at 459 U.S. 828 (1982).

We therefore respectfully submit that the Petition should be denied.

Respectfully submitted,

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